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Bell Atlantic
1300 I Street N.W.
Suite 400W
Washington, DC 20005
(202) 336-7893
Fax (202) 336-7866

Marie T. Breslin
Director
Government Relations - FCC

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February 11, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

EX PARTE

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: CC Docket 96-128, Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996

Dear Ms. Salas:

Today, Michael Kellogg of Kellogg, Huber, Hansen, Todd & Evans and the undersigned, representing the RBOC/GTE/SNET Payphone Coalition, met with Kyle Dixon, Legal Advisor to Commissioner Powell. The purpose of the meeting was to provide a background briefing on payphone issues. Attached is a copy of the handout used in the meeting.

Please include a copy of this correspondence in the public record of the above-captioned proceeding.

Sincerely,

Marie Breslin

Attachment

cc: K. Dixon

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List ABCDE

RBOC/GTE/SNET PAYPHONE COALITION

February, 1998

Payphones Prior to the 1996 Act

- Computer II excluded coin-operated payphones from the definition of CPE (1980).

- Coin Registration Order recognized the right of non-LEC providers to interconnect smart payphones with the public switched network (1984).

- LEC payphones subsidized by federal access charges and, in some cases, also by state access charges.

- Payphones did not receive fair compensation on many calls.
  - Most states kept local coin rates artificially low.
  - RBOCs precluded from negotiating commissions on 0+ calls.
  - Telephone Operator Consumer Services Improvement Act ("TOCSIA") eliminated IXC incentives to negotiate commissions on dial-around and access code calls (1990).

Section 276 of the 1996 Act

Overarching Goals: To "promote competition among payphone service providers and promote the widespread deployment of payphone services to the benefit of the general public."

- Commission must ensure removal of all payphone access charge subsidies.

- Commission must prescribe, at a minimum, Computer III - type nonstructural safeguards for BOC payphones.

- Commission must ensure payphone service providers "are fairly compensated for each and every completed intrastate and interstate call using their payphones."

- BOC PSPs are to have the same right as independent PSPs to negotiate, select, and contract with IXCs for the carriage of 0+ traffic.

First Report and Order

"Full and unfettered" competition is the best way to achieve Congress' overarching goals. Report and Order, 11 FCC Rcd at 20369, ¶ 55.

- LEC payphone assets to be reclassified as unregulated CPE; subsidies to terminate by April 15, 1997. Id. at 20633, ¶ 183.

- Commission adopts Computer III-type nonstructural safeguards for BOC payphones. Report and Order, 11 FCC Rcd at 20640, ¶ 199.

- Fair compensation is market-based compensation:
  - Deregulation of local coin rate by October, 1997. Id. at 20572, ¶ 60.
  - PSPs may negotiate compensation on 0+ calls. Id. at 20661, ¶ 240.
  - IXCs must track all dial-around and 800 calls and pay compensation. Id. at 20586, ¶ 86.

- BOC PSPs authorized to negotiate, select, and contract with IXCs for the carriage of traffic, subject to existing IXC contracts with location providers. Id. at 20661, ¶ 240.

First Report and Order: Per-Call Compensation

- Commission rejects cost-based approach to determining per-call compensation. Report and Order, 11 FCC Rcd at 20576, ¶ 68.

- Default rate to be based on local coin rate as market-based surrogate. Id. at 20577, ¶ 70.
  - Local coin rate is determined competitively. Id. at 20578, ¶ 72.
  - IXCs have "substantial leverage" to negotiate lower per-call rates because of their call-blocking capability. Order on Recon., 11 FCC Rcd at 21269, ¶ 71.

- Interim compensation to be based on default rate.
  - IXCs to pay interim compensation of $45.85 (131 calls originated from average payphone multiplied by $0.35) for one year. Id. at 20604, ¶ 125.
  - IXCs to pay interim compensation at a negotiated rate or at the default rate of $0.35 for each compensable call for the following year. Id. at 20578, ¶ 72.

Commission's Original Order Largely Upheld on Review

- D.C. Circuit approved deregulation of the local coin rate.
  - "A market-based approach is as much a compensation scheme as a rate-setting approach." Illinois Public Telecomm. Ass'n, 117 F.3d 555, 563 (D.C. Cir. 1997)
  - "[I]t was not unreasonable for the Commission to conclude that market forces generally will keep prices at a reasonable level." Id. at 562.

- Court upheld "carrier pays" and IXC tracking requirement; Court agreed that IXCs can "block" calls and negotiate a lower rate. Id. at 564, 566-67.

- Court found no fault with Commission's decision to reject cost-based methodology in determining per-call compensation. Cf. id. at 563.

- But Court rejected decision to set default rate equal to deregulated local coin rate
  - Commission had stated that "cost[s] of originating the various types of payphone calls are similar." Report and Order, 11 FCC Rcd at 20577, ¶ 70, but the record contained evidence that costs are not similar. The Commission was required on remand to consider these alleged cost differences.

- Court also mandated interim compensation for BOC 0+ and inmate calls. 117 F.3d at 565-66.

Second Report and Order: Avoided Cost Pricing

- Avoided Cost Pricing Bases Per-Call Rate on Market Price:
  - Market forces will produce better service, lower costs, widespread deployment.
  - Market price *is* the "fair" price: "[T]he PSP will be providing a competitive service (payphone use) and should therefore receive compensation equal to the market-determined rate for providing this service." <u>Recon. Order</u>, 11 FCC Rcd at 21267, ¶ 68.

- Avoided Cost Pricing Starts with the Competitive Local Coin Rate:
  - Payphone market has "low entry and exit barriers" and "market will determine the fair compensation rate for [local coin] calls." <u>Report and Order</u>, 11 FCC Rcd 20577, ¶ 70.

- Avoided Cost Pricing Adjusts for Differences in Costs
  - "We . . . reduc[e] the market-based local coin rate to reflect coin-related costs and increas[e] the market-based local coin rate to reflect costs that are related to [coinless] calls." <u>Second Report and Order</u> ¶ 26.
  - Addresses the Court's sole criticism of the First Report and Order.
  - Ensures that "each call placed at a payphone . . . bear[s] an equal share of joint and common costs." <u>Id.</u> ¶ 42.

Tasks Remaining for the Commission

- The Commission must issue its Order on Reconsideration, adjusting the application of the avoided cost pricing methodology.

- The Commission must address interim compensation and should do so with all possible speed.

Commission Should Correct Flaws in the Second Report and Order

- The Commission Failed to Account for Demand Differences
  - Competitive firms allocate larger share of joint and common costs to products for which demand is less elastic.
  - Demand for local coin calls is more elastic than demand for access code and subscriber 800 calls.
  - Per-call rate should therefore be <u>higher</u> than the local coin rate.
  - Expert analysis of demand conditions indicates that the per-call rate should be $.42 - $.43.

- The Commission Ignored Market Results
  - IXC payments to PSPs on collect and credit-card calls ("0+ and 0- calls") average between $.78 and $1.33 per call.
  - These payments are a better market surrogate for the per-call rate than the local coin rate.

- Coin Mechanism Costs are Not Avoided Costs
  - But for the coin mechanism, the payphone <u>would not exist</u>. The coin mechanism benefits coin callers <u>and</u> coinless callers.
  - Per-call costs are <u>higher</u> for a coinless phone than for a coin-capable phone; coin mechanism costs were overstated in any event.

- The Commission Improperly Ignored Bad Debt and Collection Costs

- The Commission Understated Per-Call ANI ii Costs
  - Costs should be allocated to coinless calls only, <u>not</u> all calls.

Commission Should Continue to Reject Cost-Based Approaches

- Cost-based approach does not equal "fair" compensation

- Cost-based approach either ignores widely different actual costs (among PSPs and in different states) or creates an administrative nightmare.

- Cost-based approach fails to support payphones that are competitively justified but that have below average usage or above average costs.
  - "A cost-based compensation standard could lead to a reduction in payphones by limiting a PSP's recovery of its costs, and this result would be at odds with the legislative purpose of Section 276 [to] 'promote the widespread deployment of payphone services to the benefit of the general public.'" Order on Recon., 11 FCC Rcd at 21267, ¶ 66.

The Commission Must Require IXCs to Pay Interim Compensation

- LECs removed hundreds of millions of dollars in federal and state payphone subsidies as of April 15, 1997.

- IXCs have flatly refused to pay interim compensation.

- IXCs owe LECs over 300 million dollars in interim compensation.

- Commission must require prompt and full payment of interim compensation amounts
  - No "state certification" or other evidence of compliance with the requirements of the Payphone Orders is required for LEC PSPs to be entitled to per-call compensation.
  - "[T]he Commission did not establish a requirement that LEC PSPs obtain a formal certification of compliance from the Commission or the states to receive per-call compensation." <u>Second Report and Order</u>, ¶ 1 n.9.
  - IXC claims of non-compliance may be pursued before the Commission; they do not provide an excuse to avoid compensation obligations.

- Interim Compensation Formula:
  - $.284 x (131 + average of uncompensated 0+ and 0- calls), with additional compensation for BOC inmate calls

The IXCs Have Lined Their Pockets

- The IXCs have raised their rates repeatedly to pay for per-call compensation.

- AT&T, for example, raised its 800 rates at least three times:
  - On February 27, 1997, AT&T raised toll-free rates by 3 percent and imposed a $.15 per call charge for business credit card calls.
  - On May 1, it raised its interstate toll-free rates by 7 percent and business international and interstate outbound services by 2 percent.
  - On June 1, it added another $.35 per-call charge for calling card calls, reduced to $.28 in October.
  - Starting November 1, AT&T imposed a $.28 per-call surcharge for toll-free calls from payphones.

- Sprint and MCI have raised their rates in similar fashion.

- Virtually none of this has been passed on to PSPs.